
Highlights of the temporary regulations under Section 245A

June 18, 2019

In brief

Treasury and the IRS on June 14, 2019, released 105-page [temporary regulations](#) (the Temporary Regulations) under Section 245A as enacted by the [2017 tax reform legislation](#) (the Act). The regulations seek to limit the benefits of section 245A where “the literal effect of section 245A would reverse the intended effect of the subpart F and GILTI regimes.”

In particular, the Temporary Regulations limit the otherwise available dividends received deduction (DRD) under Section 245A for certain dividends received from current or former controlled foreign corporations (CFCs) where: (1) a related-party extraordinary transaction was executed by the CFC on or after January 1, 2018, in a tax year to which Section 951A did not apply to such CFC, or (2) a transfer or issuance of stock on or after January 1, 2018, resulted in a reduction in a US shareholder’s pro rata share of the CFC’s subpart F or tested income. The Temporary Regulations also limit the applicability of the look-through exception to foreign personal holding company income for certain dividends received by upper-tier CFCs from lower-tier CFCs in similar circumstances.

Taxpayers that have executed transactions similar to those described should immediately review the Temporary Regulations and determine the impact, if any, on distributions made after December 31, 2017.

Some of the key highlights we have identified thus far are set forth below. In addition, we will discuss the Temporary Regulations on a future webcast.

In detail

Background

Section 245A generally provides a 100% DRD for the foreign-source portion of dividends received by a US corporation from a foreign corporation with respect to which the US corporation is a 10% shareholder (a 245A shareholder).

Section 954(c)(6) generally provides an exception to foreign personal holding company income for dividends, interest, rents, and royalties received by a CFC from a related CFC that are not attributable to subpart F income or income effectively connected with a US trade or business of the payor.

In order to mitigate use of such provisions in specific transactions to avoid the inclusion of income under the subpart F rules or Section 951A, Treasury and the IRS issued the Temporary Regulations.

Highlights of the Temporary Regulations

The Temporary Regulations, released June 14, 2019, include rules that apply to limit the application of Sections 245A and 954(c)(6) for distributions received by current or former CFCs. The following is a high-level summary of the key provisions in the Temporary Regulations.

Limitation of DRD

In general, a 245A shareholder is allowed a DRD for the foreign-source portion of a dividend from a specified 10% owned foreign corporation (a SFC) under Section 245A(a). However, the Temporary Regulations provide that the amount of DRD allowed with respect to a dividend is limited to the amount that exceeds the sum of 50% of the extraordinary disposition (ED) amount plus 100% of the extraordinary reduction (ER) amount.

Extraordinary disposition amount - In general

The Temporary Regulations provide that the ED amount is the portion of a dividend received by a 245A shareholder from a SFC paid out of the 245A shareholder's ED account.

The ED account relates to transactions executed during the 'disqualified period,' which begins on January 1, 2018, and ends on the last day of the SFC's tax year (if the SFC's tax year begins before January 1, 2018, and ends after December 31, 2017).

In general, the account represents the shareholder's share of the SFC's ED E&P. The shareholder's share generally reflects its ownership interest in the SFC (by value) at the beginning of the disqualified period.

The Temporary Regulations provide that a SFC's ED E&P is the total net gains from transfers of specified

property during the disqualified period to related persons outside the ordinary course of the SFC's activities. This includes the SFC's share of any gains from transfers executed by specified entities (i.e., any partnership, flow-through, etc. in which the SFC directly or indirectly owns an interest) that would have otherwise been treated as an ED if it were a foreign corporation.

To the extent that the net gains do not exceed the lesser of \$50 million or 5% of the gross value of all the SFC's property, no ED account is created with respect to such SFC.

For this purpose, specified property is any property that does not produce income excluded from tested income under Section 951A(c)(2)(A)(i)(I)-(V) (or the portion of property not giving rise to such income).

The determination of whether a transfer is outside the ordinary course of an SFC's activities is based on a facts and circumstances analysis. Transactions executed with a principal purpose of generating E&P during the disqualified period and dispositions of intangible property, as defined under Section 367(d)(4), are per se outside the ordinary course of the SFC's activities.

The ED account is reduced by the prior ED amount, generally including: (1) dividends received by 245A shareholders that would have been ED amounts; (2) portions of dividends that were included by an upper-tier CFC as foreign personal holding company income by reason of Section 245A(e); and (3) 200% of prior dividends received from a lower-tier CFC that gave rise to a tiered ED account (as discussed below).

In determining the portion of a dividend that is from the 245A shareholder's ED account, dividends of Section 959(c)(3) E&P in excess of the disposition account are deemed to

be paid first. Thus, dividends related to the 245A shareholder's ED account are ordered last.

The Temporary Regulations also provide successor provisions whereby, to the extent stock in a SFC is transferred or the SFC is party to a Section 381 transaction, the 245A shareholder acquiring stock in the SFC succeeds to the ED account.

Extraordinary disposition amount - Tiered ED accounts and limitation on Section 954(c)(6)

The Temporary Regulations provide a corresponding limitation on the application of Section 954(c)(6) to dividends received by upper-tier CFCs from lower-tier CFCs.

In general, Section 954(c)(6) does not apply to 50% of the sum of 245A shareholders' 'tiered ED amounts' with respect to the lower-tier CFC (grossed up to account for non-US shareholders by dividing such by the percentage of stock in the upper-tier CFC held by US shareholders that include in gross income such entity's subpart F income under Section 951(a)). The tiered ED amount with respect to the lower-tier CFC is the amount that would have been an ED amount if the 245A shareholder held its pro rata share in such lower-tier CFC directly.

Extraordinary reduction amount - In general

The ER amount with respect to a dividend received by a controlling 245A shareholder (i.e., a 245A shareholder owning directly or indirectly more than 50% of the stock of a CFC) from a CFC after December 31, 2017, is the lesser of the dividend and the controlling 245A shareholder's pre-reduction pro rata share of the CFC's subpart F income and tested income, reduced by prior ER amounts.

The pre-reduction pro rata share of the CFC's subpart F income and tested income is the amount of such items that would have been included by the controlling section 245A shareholder immediately before the extraordinary reduction, reduced by the amount of subpart F income and tested income actually included in gross income by US persons with respect to the CFC for the CFC's taxable year.

An extraordinary reduction is either:

- 1) a transfer, either directly or indirectly, of more than 10% of the value a controlling 245A shareholder's interest in a CFC (other than in an F or E reorganization), provided the transfer represents at least 5% of the value of all CFC stock; or
- 2) one or more transactions that result in the percentage of stock owned by the controlling 245A shareholder being less than 90% of its ownership on either the day it held its highest ownership (by value) in the CFC during the tax year or the day immediately before the transfer, provided that the change is at least 5 percentage points.

An ER does not include a transaction that results in the close of a CFC's tax year where the controlling 245A shareholder includes its pro rata share of subpart F and tested income.

Further, the ER amount is reduced by prior ER amounts, generally including: (1) dividends received by 245A shareholders that would have been ER amounts; (2) portions of dividends that were included by an upper-tier CFC as foreign personal holding company income by reason of Section 245A(e); and (3) prior dividends received from a lower-tier CFC that gave rise to a tiered ER account (as discussed below).

Extraordinary reduction amount - Exceptions

The Temporary Regulations provide an election for controlling 245A shareholders to close the CFC's tax year for all US federal income tax purposes as of the end of the date on which the extraordinary reduction occurs. This election must be made by all controlling 245A shareholders and requires such shareholders to include a statement with the US tax return for the year of the transaction and a binding agreement must be made for all controlling 245A shareholders to respect such tax year end. Such election must be made consistently for all CFCs of the controlling 245A shareholder.

Where an election is made and the local country tax year does not end, foreign income taxes are allocated between the US tax years that comprise the foreign tax year based on the respective portions of taxable income of the CFC (as determined under foreign law) attributable to the periods during the foreign tax year.

Additionally, to the extent that the sum of the CFC's subpart F income and tested income for the taxable year does not exceed the lesser of \$50 million or 5% of the CFC's total income for the year, no amount is considered a ER amount.

Extraordinary disposition amount - Tiered ER accounts and limitation on Section 954(c)(6)

The Temporary Regulations also provide for a corresponding limitation on the application of Section 954(c)(6) to dividends received by upper-tier CFCs from lower-tier CFCs.

In general, Section 954(c)(6) does not apply to an upper-tier CFC's pre-ER ownership (by value) in the lower-tier CFC multiplied by the lower-tier CFC's subpart F and tested income for the

year. This amount is reduced in a similar manner as the reductions for prior ER amounts.

Anti-abuse rules

The Temporary Regulations include broad anti-abuse language, allowing for adjustments to any transaction undertaken with a principal purpose of avoiding the purposes of the regulations.

Special rules to ED and ER amounts

In general, the Temporary Regulations provide that the rules governing Section 245A(e) are intended to apply first, followed by rules pertaining to ER amounts, and followed finally by rules pertaining to ED amounts.

Further, for purposes of applying the provisions with respect to deemed dividends under Section 964(e)(4) from lower-tier CFCs included in the US shareholder's income under Section 951(a), both the ED amounts and ER amounts are determined as if the lower-tier CFC paid a dividend directly to the 245A shareholder.

Effective date

The Temporary Regulations apply retroactively to distributions occurring after December 31, 2017.

The takeaway

The Temporary Regulations limit the application of Sections 245A and 954(c)(6) for distributions received from current or former CFCs as a result of the execution of certain transactions.

Taxpayers should immediately review the Temporary Regulations to determine whether transactions executed on or after January 1, 2018, could impact application of Sections 245A or 954(c)(6).

The above-mentioned highlights are not an exhaustive list of the provisions in the Temporary Regulations.

See also:

[House and Senate tax reform proposals could significantly impact US international tax rule](#)

Let's talk

If you would like to discuss how these developments may affect your business, please contact:

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